



STATE OF CALIFORNIA

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October 7, 2013

VIA INTERNET

CYNTHIA BRIDGES  
Executive Director

Dear Interested Party:

The Audit Manual (AM) is a guide for the Board of Equalization (BOE) staff in administering tax and fee programs. It is available to the public and can be accessed from the BOE web page at <http://www.boe.ca.gov/sutax/staxmanuals.htm>.

The Sales and Use Tax Department (SUTD) is proposing to add AM section 0421.00, *Audit of Nontaxable Electronic Sales and Purchases of Computer Software*, to clarify the audit verification procedures for establishing the nontaxable sale of prewritten programs via electronic download and load-and-leave transactions. The proposed section is provided on the following page for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons.

If you have any comments or suggestions related to the proposed AM revision, you may contact the BOE at [AM.RevisionSuggestions@boe.ca.gov](mailto:AM.RevisionSuggestions@boe.ca.gov). Your comments or suggestions must be received by BOE no later than **December 6, 2013** in order to be considered by staff. Thank you for your consideration.

Sincerely,

Susanne Buehler, Chief  
Tax Policy Division  
Sales and Use Tax Department

# **AUDIT OF NONTAXABLE ELECTRONIC SALES AND PURCHASES OF COMPUTER SOFTWARE**

**0421.00**

## **INTRODUCTION**

**0421.01**

This section provides guidance regarding the uniform documentation standards and audit procedures to be used in the verification of claimed nontaxable sales and purchases of electronically transferred computer software, including software electronically transferred pursuant to a software maintenance contract, and software transferred by the “load-and-leave” process.

Sales of prewritten software and software maintenance contracts are not taxable transactions if the seller transfers the software via:

- (1) Remote telecommunications to the purchaser’s computer; or
- (2) Installation of the software directly into the permanent storage memory of the customer’s computer, unless the installation is part of the sale of the computer (“load-and-leave”).

In both cases, in order for tax not to apply, no tangible personal property, such as storage media, may be transferred in the transaction.

A software vendor may electronically transfer software or periodic software upgrades or updates directly to a purchaser’s computer over the Internet, or by a “load and leave” process.

## **SOFTWARE TRANSFERRED BY A “LOAD-AND-LEAVE” PROCESS**

**0421.02**

A sale of software by the “load-and-leave” process requires the seller, the seller’s employee, or the seller’s agent to personally install the software directly into the permanent storage memory of the customer’s computer, and requires that the installation is not part of the sale of the computer. When software is transferred via “load-and-leave,” the seller or seller’s agent must retain title and possession of the storage media containing the software during the entire installation process. Any transfer of title or possession of the storage media containing the software to the purchaser, however temporary, will render the transaction taxable. During the “load-and-leave” process, the period of time the seller’s storage media is connected to the customer’s computer is not considered a temporary transfer provided that the seller or seller’s agent maintains control of the loading process and retains title to and possession of the storage media/device at all times.

## **SALES AND PURCHASES OF SOFTWARE TRANSFERRED ELECTRONICALLY**

**0421.03**

Sales and purchases of software transferred electronically are not subject to tax if no tangible personal property is furnished by the seller in the transaction. In cases where tangible personal property is provided in the transaction, in any format except written documentation or manuals (including documentation or

manuals in machine-readable form) designed to facilitate the use of the program, tax applies to the original electronic transfer of the software, even when the tangible personal property is shipped subsequent to the electronic transfer of the software provided that the transfer of tangible personal property is part of the original sale of the software.

However, where the software is transferred electronically, if another copy of the software is later sold to the purchaser on tangible storage media as part of a separate and distinct transaction, tax will not apply to the prior sale of the electronically supplied copy of the software. The determination as to whether a transaction is separate and distinct will be based on the facts and circumstances, and evaluated on a case-by-case basis.

In some cases, electronic delivery of the software will be initiated by customers by going to the seller's website to download a copy of the software to their computers. In those cases, the seller will transmit an access code, or "key," that customers must use to activate the software. Some software providers may use the "Software as a Service," or a similar model, in which: (1) customers can access the software on a remote network or location, (2) customers do not receive a copy of the software, electronic or otherwise, and (3) the seller retains possession and control of the software at all times. Under these conditions, tax does not apply to charges for "Software as a Service" and similar transactions.

Some sellers may give customers the option of receiving the software either electronically or through the transfer on a tangible storage media. Sellers that provide such an option should maintain separate and distinct product codes, part numbers or stock keeping units (SKU) for the electronic delivery and storage media delivery modes. The seller's billing system should then add or not add sales or use tax to the sale, depending on whether the product code is for the storage media version or the electronic version. The seller may have multiple software products having different distribution methods associated with each product. For instance, a particular software product may only be available to customers through electronic delivery, while another may be obtained either electronically or on storage media.

When the sale of prewritten software is a nontaxable transaction, the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge. The transfer of such documentation does not make an otherwise nontaxable electronic transfer of prewritten software subject to tax.

## **AUDIT PROCEDURES FOR SALES**

**0421.04**

Auditors should be mindful that the prevailing business practice in the software industry is to transfer software electronically without providing a copy of such software on tangible storage media. When reviewing claimed nontaxable sales of

electronically transferred software, the auditor should conduct a review of the taxpayer's business practices, policies, procedures, and the company website (if one exists) to gain an understanding of the method(s) used to sell, transfer, or distribute software to its customers.

There may be multiple sources of evidence to substantiate the nontaxable transfer of software. Nontaxable transfers of software can be supported by sales invoices, sales contracts, purchase orders, specific exemption certificates, as provided in Regulation 1667, *Exemption Certificates*, and other contemporaneous documents and correspondence. The exemption certificate should include a statement providing that "the software will be transferred electronically and no copy will be furnished to the purchaser on tangible storage media." This statement may also be included in other contemporaneous documents or correspondence, such as sales invoices or sales contracts, and used to support the nontaxable transfers of software programs.

Staff should accept the taxpayer's claimed exemption for sales of electronically transferred software when staff has conducted preliminary testing (informal spot or random tests) and found that no exceptions exist and staff is satisfied that:

- The taxpayer's policy and common practice is not to transfer a tangible copy of the software to the purchaser,
- There is no documentation to support that such transfers occurred.

Additional "controlled" testing should be conducted when exceptions exist. An auditor should always keep in mind the general auditing procedures and techniques outlined in this chapter, including short tests and cut-off techniques. As with other types of sales, large dollar transactions may be stratified for review on an actual basis, as deemed appropriate by the auditor.

## **Reviewing Individual Transactions**

Where the sales contract, sales invoice, exemption certificate, or other evidence indicates that the software was transferred electronically, the auditor should generally accept the transaction as nontaxable, unless there is other affirmative evidence that a copy of the software was furnished on tangible storage media in the transaction (e.g., an invoice shows shipping charges).

Where there is ambiguity or contradictory information/documentation regarding whether a transfer of tangible personal property occurred, the auditor should use appropriate auditing procedures to resolve the issues. The auditor may request copies of shipping documents, billing statements, or other documentation to determine whether copies of software on tangible storage media were transferred to buyers. File Transfer Protocol (FTP) logs, and any other pertinent information also may be used to support the taxpayer's claim that the software was transferred electronically.

An auditor should not conclude that software was transferred on tangible storage media based solely upon the absence of documentation in the seller's FTP logs. However, deficient or nonexistent FTP documentation in conjunction with other

contradictory information (such as a shipping charge on an invoice) may be indicators that tangible personal property was transferred. In addition, an auditor should not conclude that software was transferred on tangible storage media based upon the fact that a sales invoice has the “ship to” address field completed. There may be valid business reasons to include a “ship to” address on the invoice, even though no tangible personal property was actually shipped. For instance, many common billing systems automatically populate the “ship to” field with the same information that is in the “bill to” field if there is no “ship to” address. Additionally, the seller may have its billing system set up to track electronic transfers to states where downloads are subject to tax. The absence of documentation in the seller’s FTP logs or a sales invoice with the “ship to” address field completed should not be considered affirmative evidence showing the software was delivered via tangible personal property.

### **Access Code or ‘Key’**

When software is transferred by “pulling” the software and using an access code or “key,” the taxpayer should retain the email in which the access code or “key” was sent to the customer as support that the software was transferred electronically. *An auditor should be aware that charges for the use of an access code or “key” to “unlock” software programs or features previously transferred on tangible storage media or equipment are subject to tax.*

### **“Load-and-Leave” Transactions**

For “load-and-leave” transactions, auditors should verify that the taxpayer has a written statement signed, at the time of loading, by the purchaser, purchaser’s employee, or purchaser’s agent and the seller’s employee or seller’s agent who loaded the software on the purchaser’s computer with the following or similar language:

“The software program, [name of software program], was loaded on the computer of [purchaser’s name] by [seller’s employee or seller’s agent that installed the program], and [seller’s employee or seller’s agent] did not transfer any tangible personal property containing the software, such as tangible media, to [purchaser’s name].”

When such a statement is signed at the time the software program is loaded, it will be rebuttably presumed that the software program was not transferred on tangible storage media. If there is no such timely completed statement, the seller/buyer may provide other substantive evidence establishing that the software was not transferred on tangible storage media.

Lastly, the seller may use either BOE-504-CSW (paper version) or Form BOE-504-CSW1 (electronic version) – *Statement Concerning Property Purchased Without Payment Of California Sales Tax - Software*, to support its assertion that a copy of the software or software updates were not transferred to the purchaser on tangible storage media.

## **AUDIT PROCEDURES FOR PURCHASES**

**0421.05**

As purchasers of software may utilize multiple vendors, we cannot presume, as we do for sellers, they have a common practice regarding electronically transferred software. When examining purchases of software, staff must review the documentation used to support software purchases. Staff should look for language indicating the software was transferred electronically and that no tangible copy of the software was furnished to the purchaser.

Acceptable supporting documentation includes sales invoices, sales contracts, purchases invoices and other contractual language providing the software will be transferred electronically and no tangible copy will be furnished to the purchaser. Additionally, staff should determine whether the purchaser was billed for transportation charges in connection with electronically transferred software, which could indicate that a tangible copy of the software was shipped to the purchaser.

If the auditor still has questions as to the method of delivery, they may find it helpful to gain insight as to the seller's business practice. One way to do so would be to determine whether the seller has been audited and if so, contact the auditor of the seller.

## **DONGLES**

**0421.06**

A dongle, which is considered tangible personal property, is a security device used to prevent unauthorized reproduction of software and/or to make the software fully functional. Even in cases where the dongle is "optional," when the dongle is provided as part of the sale of software the seller is deemed to be selling a single item, as the true item sold is software subject to a physical security device without which the software will not function properly.

The inclusion of a dongle in connection with the transfer of software renders the entire transaction to be a taxable sale of tangible personal property. Whether the charge for the dongle is separately stated or not, even if sold subsequent to the transfer of the software under a separate invoice, the charges for the software (unless the software program qualifies as a custom program) and for the dongle are subject to tax. This is true even in cases where the purchaser is not contractually required to purchase the dongle, provided the purchaser must acquire the dongle to operate the software.

## **ANNUAL SOFTWARE LICENSE RENEWALS**

**0421.07**

Tax generally applies to the gross receipts from the sale of annual software license agreements when the original agreement provides for the delivery of copies of the software on tangible storage media to the buyer. This is true regardless of whether or not upgrades or updates provided through the License Agreement are subsequently transferred electronically. For guidance with respect to upgrades

and updates furnished pursuant to optional software maintenance contracts, see Section 0421.08.

In cases where the original software sale is subject to tax, tax applies to annual software license renewals without regard to the length of time which has elapsed or the changes resulting from the upgrades previously provided. Tax applies in the same manner whether there is a single, multi-year agreement or multiple single year agreements.

However, tax does not apply to the gross receipts from annual software license renewals when the software updates or upgrades are electronically transferred, and the original sale of the software was not taxable because the software was transferred to the licensee electronically and no copies of the software on tangible storage media were furnished with prior updates. Audit procedures, when necessary, should be performed in substantially the same manner as other sales and purchase transactions.

## **OPTIONAL SOFTWARE MAINTENANCE CONTRACTS**

**0421.08**

A software maintenance contract is an agreement requiring the seller of software to provide the customer with either technical support services or software upgrades and updates, or both. A maintenance contract is optional if the purchaser may purchase the software without also purchasing the maintenance contract. If the purchase of the maintenance contract is optional and there is a single lump sum charge for the maintenance contract, pursuant to [Regulation Section 1502\(f\)\(1\)\(C\)](#), tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract. If no tangible personal property is transferred to the purchaser during the term of the maintenance contract, tax does not apply to any portion of the charge. Therefore, if the terms of an optional software maintenance contract explicitly provide that no copies of software on tangible storage media will be transferred to the purchaser, the seller is not required to report tax on any portion of the gross receipts from the sale of the optional software maintenance contract (provided that no such copies are in fact transferred).

When an optional software maintenance contract is silent with respect to whether software on tangible storage media is to be transferred, or when the parties contemplate a transfer of tangible personal property, tax applies to 50 percent of the lump sum charge for the sale of an optional software maintenance contract. The transaction must be reported on the sales and use tax return for the period in which the transaction occurs. If, in fact, no tangible personal property was transferred to the purchaser during the term of the maintenance contract, the seller may file a claim for refund for the tax remitted on the sale of the maintenance contract. For procedures with respect to the treatment of excess tax reimbursement and supporting a claim for refund, refer to section 0417.00.

Substantiating whether software upgrades and updates under an optional software maintenance contract were delivered electronically or by tangible media is the same as substantiating whether software was delivered electronically.